

The European Union Taxonomy – The Revolution of Sustainable Activities

Maria-Mădălina Bogeanu-Popa
Mariana Man

University of Petroșani, Faculty of Sciences, Romania
madalinabogeanu@yahoo.com
man_mariana2006@yahoo.com

Abstract

This paper represents qualitative research of the concept of taxonomy within the European Union (EU), drafted with the sole purpose of establishing the presence of the environmental elements specific to sustainable development within the economic activity. The EU taxonomy is an important mechanism which offers coherence in using every instrument conceived for accomplishing the ecological objectives of the environment. The concept of taxonomy refers to the investment funds of big economic entities within EU and beyond, which need to provide information about their environmental related activities.

The purpose of this paper is to highlight the cooperation between the regulation authorities and the technical experts in the domain (TEG), which offer a starting point in this journey from their experience with environmental, social and governance (ESG) information reporting. Therefore, the intention EU has regarding the taxonomy is guiding the capital towards the ecological and the implementation of a new universally available classification system of sustainable investments at an international level.

Key words: EU taxonomy, environment, sustainability, sustainable investments, non-financial reporting

J.E.L. classification: Q56, M14, O44

1. Introduction

With time, a series of economy specialists and investors have taken more and more measures in integrating, within the economic activity, preoccupations regarding climate change. They have opted for sustainability through sustainable actions at a managerial level. Until recently, EU lacked a common classification system to encourage private investments towards sustainable growth and towards contributing to a neutral economy from a climate change point a view. As a result, a classification system within EU was born, called taxonomy. This provides organizations and investors a common language for identifying economic activities which can be considered sustainable from the point of view of the environment (Cremasco and Boni, 2022).

Taxonomy was born from sustainable development, conceived to encourage change regarding environmental aspects within the EU economic environment. Through taxonomy, EU tries to enhance transparency as a way of assuring economic organizations as well as the survival of truly sustainable activities. In this context, the economic entities which do not want to evolve in order to respond to the stringent needs of climate change and environmental perturbations are not promoted (European Commission, 2022).

In a broad sense, the EU taxonomy represents a classification system which establishes a list of economic activities, sustainable from an ecological point of view. The role taxonomy plays within EU is very important due to its contribution in intensifying sustainable investments within the European space. Moreover, taxonomy helps applying the European environmental agreement (Piebalgs and Jones, 2021).

Up until recently, identifying a sustainable financial investment was relatively easy to accomplish. The economic organizations could attract investors through financial and non-financial performances which were better than those of other economic actors active on the market. With that in mind, the dynamic of the economic environment, especially the decision factors of political nature, has admitted that there must be a supplementary amount of effort to stimulate investments (Kot and Măcriș, 2015). Considering this, one refers to the analysis of the commitments the economic organizations take regarding carbon emission reductions and regarding the regulations of the Paris Agreement. The latter takes into consideration climate change, presenting a long-term action plan for limiting global warming (European Council - Council of the European Union, 2021).

Moreover, it has been remarked, at a large scale, the clarification necessity of a higher level of certitude in different investment types regarding the sustainability of the investment environment and the economic activities. As a response to these preoccupations, a series of experts in the domain, representatives of EU member states, have started to create official definitions of sustainable economic activities. These documents, issued within the EU, are presented as a report whose content contains definitions regarding the taxonomies of the economic activities globally. Within the report there are included EU member states as well as Asian states such as China and Japan (European Commission, 2022).

Generally, all the definitions regarding taxonomy refer to the composition of a comprehensive classification system which can bring future benefits regarding the improvement of the economic market's quality globally. The definitions are characterized by precision and consistency and follow key words such as green investments or sustainable investments, aspects which offer trust and assurance to the investors. The benefits brought by the implementation of taxonomy include facilitating the tracking of sustainable investment fluxes (Hilde and Jona, 2021).

2. Literature review

Currently, taxonomy is governed through the 852/2020 EU Regulation, having applicability on financial markets, institutions of public interest and economic entities with over 500 employees at the date of drafting the balance. EU is a leader in developing an ecological classification system, while the other regions such as the United Kingdom of Great Britain are looking to develop a taxonomy regulation based on the criteria and the technical principles specific to the EU. Another partner headed towards taxonomy is China, which together with the EU are working with the purpose of standardizing an ecological investment system (European Commission, 2022).

At a European level, the debut of taxonomy took place in 1995, under legislative form of ecological credit as the (Green Funds Scheme). Also, within European context, France has created the GreenFin label for retail investment funds in 2015. Internationally, the concept of taxonomy and its definitions have been unanimously accepted. As a follow up, China has applied for the first time the term of Chinese taxonomy in 2015, as some projects of green obligations issued by the People's Bank of China (OECDLibrary, 2022). In 2017 Japan has launched green obligations through the Environment Ministry of Japan (MOEJ) (European Commission, 2022).

According to the European Commission, a sustainable European taxonomy would mean a uniform and harmonized classification system which would determine the types of activities which can be considered sustainable. It is expected that this approach will establish the global benchmark for financing sustainable investments and for introducing coherency within the actual complexity of labels and methodologies used in Europe (European Commission, 2022).

Considering the contribution of the Organisation for Economic Co-operation and Development (OCDE) at TEG of the EU regarding sustainable financing, the EU taxonomy admits that an economic activity cannot be truly considered sustainable if it is independent of the system in which it is found (Official Journal of the European Union, 2019).

In the EU the potential benefits of taxonomy have been recognized and in July 2020 a regulation has been adopted to establish a framework which would facilitate sustainable investments. This regulation is found under the name of “EU regulation regarding taxonomy” and it is the cornerstone of the EU's action plan regarding sustainable financing. Adopting this regulation results binding more regulation initiatives together such as the EU standard for green obligations, the EU ecological label for retail investment funds and others (European Commission, 2022).

In the specialty literature, authors such as Lucarelli, et al. (2020) declare that the most recent change in regulation needs a change of approach towards one where the disclosure of environmental aspects leads to significant changes within an economic organization.

Considering the EU's necessity of having a regulation applicable to financial instruments and the investment market, they have assumed, through taxonomy, the trial of achieving a cleaner environment, especially trying to slow down climate change (OECDiLibrary, 2022). The efforts in this direction are meant to cover multiple activity domains and they are not only addressed to the financial market. The year of 2022 has a double meaning when it comes to taxonomy: other than the reporting which will be a mandatory item, labelling will also be implemented. This means that the organizations cannot rely on policies and revelations to attract high ESG reporting shares or investments (Holly, Stéphane, and Peter, 2022).

3. Research methodology

The present study is based on qualitative research resulted from the analysis of the theoretical approach regarding the EU taxonomy and its specific sustainable investments. Resorting to the qualitative research is due to the fact that one can develop the profoundness of the analysed concepts.

The main information sources underlying the paper are represented by applicable juridical regulations and articles published in specialty magazines. The exhaustive analysis of every aspect related to the implications of the EU taxonomy is offered through the inductive and deductive mechanisms which lead the research towards the desired direction.

Considering this, the paper has the role of approaching the aspects of taxonomy and its every detail involved in the requirements of this subject. A short review of the specialty literature regarding environmental aspects contribute to the understanding of sustainable investments. Through content analysis, the text can be integrated within the category of article type papers.

In drafting this paper, its planification has been established beforehand, necessary data and information has been collected and analysed and lastly, the article has been drafted.

4. Findings

4.1. Taxonomy in global context

In global context there is a common language regarding the taxonomies of sustainable investments for international users which are willing to use this reporting instrument. However, given its early stage of implementation, taxonomy presents some gaps globally, having nonregulated sectors. For consolidating the international cooperation, the EU launched in 2019 an International platform for sustainable development (IPSF) destined to aspects referring to the international comparability of taxonomies (European Commission, 2022).

In international context, the EU taxonomy is remarked by its advanced level of offered explanations and details through elaborate definitions. Moreover, the EU taxonomy is the only reporting framework which binds environmental objectives. These elements are representative aspects to differentiate between the EU taxonomy and the global taxonomy. The EU taxonomy is the only one to include certain sectors of production whose environmental impact is hard to alleviate, such as the domain of constructions which inevitably influences environmental elements.

The identified common grounds within all taxonomies refer to reusable energy and green buildings, where the values and thresholds between concerned definitions are similar. In sectors of activity such as nonregenerative energy generation and transport, it is found that the sectorial coverage is similar between taxonomies, but the inclusion criteria differ from one regulation to another.

Through the character of economic activities regarding the intercommunity transactions, multiple organizations can find themselves in the situation where they are under the jurisdiction of multiple taxonomies. This aspect can represent an impediment when a taxonomy which reflects only one jurisdiction and the activities associated to it will not allow the coverage of all the international activities or investments. To resolve this impediment, TEG has identified certain criteria from the EU taxonomy as being of "international relevance" meaning that the users of taxonomy could use

them for economic activities outside the EU.

At an international level, the taxonomies should also be adaptable to the current knowledge and technologies. However, with technological progress comes the adjustment imposing of the transition path in order to value results obtained with time.

Aligning the two normative acts requires the continuous monitoring of the European Commission’s activities to ensure the system’s coherence. This task is difficult to accomplish considering the general approach of the regulation which includes, within the sector of constructions, the manufacturing processes of some construction products, buildings, and civil engineering works. Legislative documents approach sustainability in a broad perspective which covers the impact on the environment, circularity, harmful substances etc, but without making the connection with the regulations of taxonomy.

4.2. Application framework of taxonomy

At a European level, the application framework of taxonomy is given by the regulation regarding the establishment of a framework for facilitating sustainable developments (EU) 2020/852. The purpose of this regulation is to establish a common language for taxonomy, to define what is sustainable and what is not, and last but not least to identify the domains in which investments can have the greatest impact. For an as high as possible visibility, the EU taxonomy has created labels for green financial products, allowing the investors to identify the investments which respect the ecological criteria or the ones with low carbon emissions. Moreover, with their help, it will be clear what is the duty of those involved, beneficiaries as well as users, regarding sustainable aspects which should be taken into account.

Also, at a European level, the European Commission together with TEG have developed a technical report to establish environmental objectives regarding the EU taxonomy of sustainable investments, presented in Figure no. 1.

Figure no. 1. Connection between taxonomy objectives and EU policies and initiatives



Source: (Construction Products Europe, 2020)

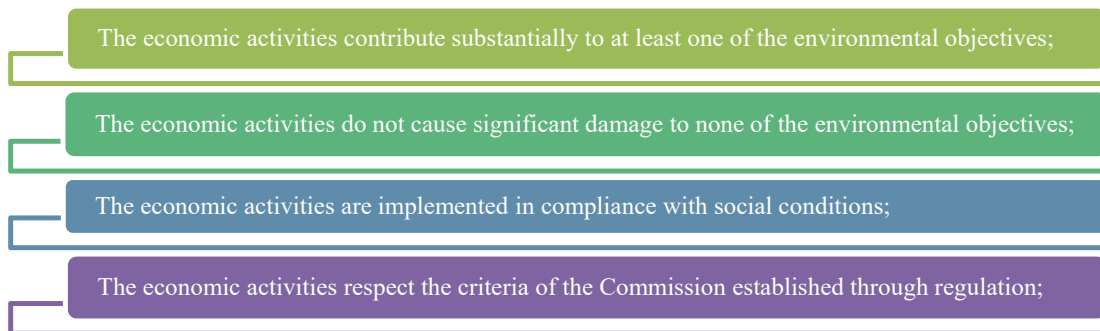
According to the figure, there are 5 great directions towards which the sustainable investments of the EU taxonomy are headed, respectively: the protection and restoration of the environment’s biodiversity, climate change of migration and adaption, water usage sustainability, water and marine resources protection, the transition towards the circular economy, pollution prevention and control. A part of these directions is also divided into subcategories which can be interconnected. Up until now, the most developed directions are related to climate change and circular economy, these two developing substantial environmental requirements.

The notion of taxonomy currently covers a wide range of environmental objectives which refer to the attenuation of climate change, pollution, circular economy, or biodiversity.

The objectives referred within taxonomy can be independent or interdependent. From a created impact point of view, for distinction, the taxonomies have a specific colour which indicates the conformity with the environment. Therefore, economic activities or financial products which already comply with environmental objectives have a deep green coloured label, and the activities which are currently in transition to be compliant with taxonomy present a light green coloured label. Also, a role has been identified for activities which are not considered compatible with environmental objectives but are integrated within taxonomy, having a brown taxonomy label.

To assess economic activities as sustainable they must fulfil a series of requirements such as those presented in Figure no. 2.

Figure no. 2. The sustainable development's requirements



Source: (European Commission, 2022)

The intentions and purpose of taxonomy have a clear initiative, and the approach must make use of the existent evaluations and methodologies to establish application criteria. In case this does not happen, a certain situation may appear referring to a parallel and contradictory regulation framework which can undermine the taxonomy’s credibility and can reduce competitiveness due to supplementary efforts when adapting to the new system.

Implementing taxonomies is intensely promoted through Government issued sponsorships which can significantly increase taxonomies in economic activities. Directing investments towards taxonomy raises the problem of the provided data availability. Similar to providing non-financial data, taxonomies need a standardization degree of the provided data to allow the aggregation and evaluation of conformity in a consequent and comparable manner. Another resemblance of taxonomy refers to its applicability within economic organizations of small dimensions. Even though current applicable regulations do not impose taxonomy application within small economic organizations, there is pressure coming from the financial market to draft conformity and verification criteria specific to taxonomy.

Through the implementation of taxonomy within the organization the decision factors are helping to develop and to grow sustainable financial markets, and therefore, accomplishing environmental objectives and other sustainable development objectives is supported.

The challenge in implementing taxonomy represents the coherence with other regulation frameworks. Therefore, a corresponding document of taxonomy is the document regarding the attenuation and adaption to climate change, whose methodology must be used to evaluate the global warming potential of buildings in conformity with the buildings’ energy performance.

4.3. EU taxonomy and the future of reporting

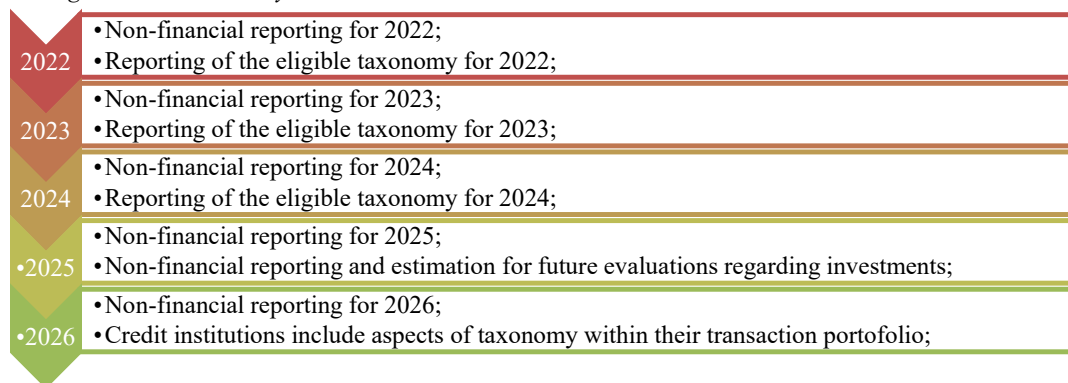
The economic organizations have made significant progress in trying to address the investors’ and regulation organisms’ pressure regarding the ESG reporting or the integrated reporting. The recent history of sustainable reporting has been marked by the absence of regulation pressure of ESG elements. During all this one may remark the efforts taken globally for assuring investors and economic organizations of implementing the objectives of sustainable development within the economic activities. At the head of these efforts was the EU which continuously tries to become “the first neutral continent from the climate perspective”. This syntagm represents a base component which is concentrated under the name of EU taxonomy. This is part of a series of extended regulations of the main actors on the economic market.

Currently, the economic market is marked by the pressure of intensifying some series of regulations which were adopted or are in the process of coming into force. Among these, the taxonomy tries to determine what is and what is not “green” within the economic activities involving the environment. Therefore, the taxonomy is the starting point for the development of the regulation labelling of the economic organizations and their activities while bearing the green or environmentally friendly label.

Taxonomy defines sustainable activities from an ecological point of view as being economic activities which substantially contribute to at least one of the EU’s environmental objectives while at the same time not being harmful to none of these objectives and also meeting the minimum social guarantees. All the participants of the financial market, all the big listed economic organizations will have to report according to taxonomy. For an economic activity to meet the sustainable definition from an ecological point of view, and therefore being considered aligned to taxonomy, it must contribute substantially to one or more of the six environmental objectives, and it must respect the development criteria.

Implementing the taxonomy signals an improvement of the non-financial reporting and the integrated reporting within EU, by directing the capital towards activities which are indisputably ecological. The taxonomy is conceived to play an important role in the transition towards an economy with low carbon emissions, offering a dynamic framework which creates transparency and comparability for the markets. One of these purposes is to offer objective criteria to evaluate the environment actions through sustainability, compared to the economic organizations which measure ESG performance just through reporting. The European Commission foresees the evolution of the EU taxonomy as having a similar trend with the one in Figure no. 3.

Figure no. 3. Taxonomy evolution



Source: (European Commission, 2022)

According to the adjacent figure, the EU’s perspectives regarding the taxonomy’s evolution follow more than the focus on environmental aspects, having as objective the identification similar to sustainable activities.

Even though the actual regulation regarding taxonomy is limited, the EU wants the list of sustainable activities to be extended in time, to cover all industries. It is true that, even though it does not approach a series of sectors and activities, it is important that the current list covers the industries

responsible for over 80% of EU’s emissions. More significant is the fact that taxonomy represents the beginning of labelling the regulated activities as being compliant or not with the climate. In a space where multiple interested parties have asked for consistency and clarity, taxonomy can be the beginning of the regulation authorities which replace the markets.

Figure no. 4. Currently covered sectors by taxonomy



Source: (European Commission, 2022)

Currently, there are 13 sectors covered by taxonomy’s regulations, according to figure 4. Out of those one may remark the absence of the agricultural sector and the fact that the energy sector is not fully covered. The EU intends on improving the current list within the next years; though, considering the limited list of activities, the organizations can ascertain that none of their activities is eligible under taxonomy, despite the fact that they possess provable sustainable accreditations or, at least they represent a minor impact on the environment.

For the economic organizations which develop activities which are not covered by taxonomy, the current form of the regulation offers motivation regarding the transition to more sustainable business activities or investments. Also, without coverage within the whole economy, it is unlikely that the regulation will have an extended adoption from investors, beyond the mandatory reporting requirements. In the current conditions the investors are looking more and more to channel the funds towards sustainable investments. The partial coverage of taxonomy, as well as the missing elements from certain activities limit more and more the hope that it will offer a fundamental change in the investment decisions.

However, the EU is looking for an expansion to open the approach by recognizing the economic activities which are developed at an intermediary level (not “green” but also not “brown”). These activities could be recognized as being a credible way towards sustainability with the condition that it does not provoke a significant prejudice. The EU also intends to create a list of economic activities which do not have significant impact on climate, to prevent those activities from suffering financial pressure to be aligned to taxonomy. These evolutions may have a positive impact on channelling funds towards “soon to be green” investments and could start to extend the taxonomy’s impact to other sectors and a higher proportion of the economy.

Where there are yet to exist technical alignment criteria to the taxonomy’s regulations, the economic organizations are encouraged to use their own values and measures and to explain the way they bind to taxonomy. The main obstacle in the taxonomy’s direction in this situation represents the insufficient financial and human resources for easily implementing the new frameworks.

5. Conclusions

Relative to the impact the non-financial information had on the economic entities, one may appreciate taxonomy as being a term which will appear constantly in future discussions and preoccupations, with its effects extending within every domain. Responding to pressure from multiple directions, the economic organizations uncover more and more the risks and opportunities

of sustainability. As the EU searches for boosting investments towards more sustainable activities, the increase in transparency by disclosing corporative sustainability and data providing is an important step in the transition towards a more sustainable economy.

One may appreciate that in the absence of taxonomy's regulations and implicitly an agreed classification framework, an improved perception of ecological accreditations without objective evaluations has been allowed. Therefore, the organizations must make use of taxonomy's requirements to implement the strategic objectives and to support the transition towards a more sustainable business project from an ecological point of view. Even though the reporting should happen from actions, the reporting requirements determine change. In this sense, the organizations will have to differentiate, gravitating in a fundamental manner towards more sustainable business practices, which would be covered by taxonomy. Taxonomy allows the access to accomplishing one of the EU's environmental objectives, leading the progress and reflecting this efficiently within reporting. These must be according to the international standards regarding sustainable investments which means that the economic activities need to become more and more sustainable.

In the face of what is most likely to be a more and more regulated aspect of corporate reporting, all organizations must watch these last-minute steps to evaluate business activities and to be prepared to refer to more exigent regulations in the following period of time. If we refer to investments, they must not only be profitable, but they must prove, based on some legislative technical criteria, the fact that the investment meets at least one of the conditions for being able to be considered sustainable.

However, some limitations of this paper must be acknowledged. Firstly, applying the classification system in a global framework, a classification system identified by the European authorities of regulation mainly for the European economic organizations. This can represent a problem for other geographical areas or countries which might have different environmental objectives and priorities. Another limitation refers to the review period of the technical criteria of the EU's taxonomy as well as the transition activities, currently being proposed at least once every three years. A solution to this limitation is the readaptation of the review time periods depending on the dynamic and the necessities which appear on the way.

In conclusion, taxonomy comes to stop investments in projects which could harm the environment, which could change even more the climate, and even more, taxonomy establishes clear rules for the investment market to direct their money towards projects which support the prevention of climate change. This regulation imposes the criteria to establish whether an economic activity is sustainable from an environmental point of view. The EU taxonomy has defined the working method and has offered a valuable example of drafting environmental policies, based on the commitment and common efforts mainly of the economic and political organization, considered essential actors for a sustainable growth from an ecological point of view.

6. References

- Construction Products Europe, 2020. *Sustainable finance taxonomy*. [online] Available at: <<https://www.construction-products.eu/publications/sustainable-finance-taxonomy/>> [Accessed 27 October 2022].
- Cremasco, C., Boni, L., 2022. Is the European Union (EU) Sustainable Finance Disclosure Regulation (SFDR) effective in shaping sustainability objectives? An analysis of investment funds' behaviour. *Journal of Sustainable Finance & Investment*, pp.1-19.<https://doi.org/10.1080/20430795.2022.2124838>
- European Commission, 2022. *A European Green Deal. Striving to be the first climate-neutral continent*. [online] Available at: <<https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal>> [Accessed 31 October 2022].
- European Commission, 2022. *Corporate sustainability reporting*. [online] Available at: <<https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting>> [Accessed 22 October 2022].
- European Commission, 2022. *European green bond standard*. [online] Available at: <<https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/european-green-bond-standard>> [Accessed 31 October 2022].
- European Commission, 2022. *EU taxonomy for sustainable activities*. [online] Available at: <<https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities>> [Accessed 22 October 2022].

- European Council -Council of the European Union, 2021. *Paris Agreement on climate change*. [online] Available at: <<https://www.consilium.europa.eu/ro/policies/climate-change/paris-agreement/>> [Accessed 21 October 2022].
- Hilde B., Jona B., 2021. Financial reporting, *Unpuzzling the Sustainability Reporting Alphabet Soup*, [online]. Available at: <<https://www.accountancyeurope.eu/wp-content/uploads/Unpuzzling-the-Sustainability-Reporting-Alphabet-Soup.pdf>> [Accessed 22 October 2022].
- Holly, P., Stéphane, M., Peter, R. 2022. *EU Taxonomy and the Future of Reporting*. [online], Available at: <<https://corpgov.law.harvard.edu/2022/04/04/eu-taxonomy-and-the-future-of-reporting/>> [Accessed 11 October 2022].
- Kot, S., Măcriș, M., 2015. Companies' Operation Environment in a Global Economy. In: C.I. Dima, ed. 2015. *Systemic Approaches to Strategic Management: Examples from the Automotive Industry*. USA: IGI Global, pp. 50- 63. <https://doi.org/10.4018/978-1-4666-6481-4.ch004>
- Lucarelli, C., Mazzoli, C., Rancan, M., Severini, S., 2020. Classification of Sustainable Activities: EU Taxonomy and Scientific Literature. *Sustainability*, 12, p.6460. <https://doi.org/10.3390/su12166460>
- OECDiLibrary, 2022. *Developing Sustainable Finance Definitions and Taxonomies*. [online] Available at: <https://www.oecd-ilibrary.org/sites/134a2dbe-en/index.html?itemId=/content/publication/134a2dbe-en> [Accessed 22 October 2022].
- OECDiLibrary, 2022. *The European Union sustainable finance taxonomy*. [online] Available at: <<https://www.oecdilibrary.org/sites/134a2dbeen/1/3/2/1/index.html?itemId=/content/publication/134a2dbeen&csp=062998fb6eb20cf4e25d9a4ba3ba529e&itemIGO=oecd&itemContentType=book>> [Accessed 27 October 2022].
- Official Journal of the European Union, 2019. *Regulation (EU) 2019/2088 of the European Parliament and of The Council of 27 November 2019 on sustainability-related disclosures in the financial services sector*. [online] Available at: <<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088>> [Accessed 22 October 2022].
- Piebalgs, A., Jones, C., 2021. The importance of the EU taxonomy: the example of electricity storage. *Policy Briefs*, [online] Available at: <https://hdl.handle.net/1814/70475> [Accessed 22 October 2022]. <https://doi:10.2870/886395>